



Paloma Petroleum Ltd.



CORPORATE INFORMATION

DIRECTORS:

Walter J. Adams, Calgary, Alberta
G. Clarence Elliott, Winnipeg, Manitoba
W. Roy Jennings, Calgary, Alberta
Mark M. Pankowski, Calgary, Alberta
John E. Stobart, Calgary, Alberta

OFFICERS:

Walter J. Adams, Chairman of the Board
John E. Stobart, President
Gordon W. Meggison, Secretary-Treasurer

HEAD OFFICE:

1150 Guinness House
727 - 7th Avenue S.W.
Calgary, Alberta
T2P 0Z7

TRANSFER AGENT AND REGISTRAR:

Montreal Trust Company,
Calgary, Montreal, Toronto, Vancouver

LEGAL COUNSEL:

McLaws & Company
Calgary, Alberta

AUDITORS:

Peat, Marwick, Mitchell & Co.
Calgary, Alberta

BANKERS:

The Toronto Dominion Bank,
Main Branch, Calgary
Canadian Commercial & Industrial Bank,
Calgary

SUBSIDIARY COMPANIES:

Compass Investments of Alberta Limited
Compass Resources Ltd.
Conquest Oil & Mining Ltd.
Conquest Resources, Inc.
Grenville Exploration Limited
Grizzly Petroleum Limited
Paloma Petroleums, Inc.

ANNUAL MEETING

The Annual General Meeting of the Shareholders will be held on May 17, 1979 in Salon A and B, Holiday Inn, 708 - 8th Avenue S.W., Calgary, Alberta, at 2:00 P.M.



CORPORATE HIGHLIGHTS

FINANCIAL

	1978	1977
Gross revenue	\$ 7,563,689	\$ 7,730,802
Funds provided from operations	3,790,372	2,662,140
Per share	.88	.63
Net earnings before extraordinary items	1,555,152	728,419
Per share	.36	.17
Net earnings	2,121,599	1,037,097
Per share	.49	.24

OPERATIONS

Natural gas sales (MCF)	4,298,169	4,004,541
Daily average	11,776	10,971
Crude oil and condensate production (barrels)	169,546	166,758
Daily average	465	457
Proven reserves:		
Natural gas (MCF)	73,503,000	78,215,000
Crude oil and condensate (barrels)	1,954,219	1,940,951
Probable additional reserves:		
Natural gas (MCF)	18,155,000	19,073,000
Crude oil and condensate (barrels)	423,513	350,564
Land holdings including royalty interests*		
Gross acres	938,267	905,715
Net acres	149,916	138,083
Wells drilled		
Gas	35	27
Oil	6	1

*1977 land holdings have been re-stated.



REPORT OF THE DIRECTORS TO THE SHAREHOLDERS



We are pleased to report significant improvements in the financial affairs of the Company. Funds provided from 1978 operations increased 42% to \$3,790,372 from \$2,662,140 the previous year. Earnings before extraordinary items increased 113% to \$1,555,152 from \$728,419 in 1977. The 1978 average rate of return on shareholders' equity is 26.8%.

During 1978 Paloma reorganized its debt structure by replacing a number of short-term production loans with a \$12 million 12-year loan secured only by Paloma's interest in the Dunvegan field. In addition to improving its working capital position, Paloma will now be able to draw on additional funds for new projects or acquisitions.

Paloma acquired the minority interest in a subsidiary company, Compass Investments of Alberta Limited, through an exchange of Paloma shares for the shares held by the minority interests of the subsidiary. All of the subsidiary companies are now wholly-owned.

Paloma sold the Mayfair Hotel in Edmonton during 1978, thus disposing of the last of its hotel properties. Proceeds from this and other property sales during the year were directed towards oil and gas projects.

During 1978, Paloma participated in 57 wells which resulted in 35 gas and 6 oil discoveries. Gas production averaged 11.8 MMCF per day, up 7% from 1977; oil production at 465 barrels per day remained about the same.

Gas marketing problems persisted throughout 1978, especially in the warmer months. We currently have 77% of our gas reserves on stream; 23% of our reserves are shut-in waiting on markets. The wellhead price of Alberta gas is \$1.57 per MCF and \$12.75 per barrel for oil. Price increases of \$1.00 per barrel are scheduled for July 1, 1979 and January 1, 1980. Gas price increases are also expected based on an 85 per cent heating value relative to oil. Because of upward pressures on world crude oil prices and the need to develop expensive heavy oil in western Canada, it appears that future Canadian oil and gas price increases could be very significant.

Our exploration efforts in 1978 resulted in the discovery of 13,930 MMCF of gas and 274,512 barrels of oil and liquids. For comparison, our production for the year was 4,298 MMCF of gas and 169,546 barrels of oil and liquids. Our reserves, which we believe to be conservatively estimated, will provide a 21.3 year supply of gas and 14.0 year supply of oil and liquids based on current rates of production. In east-central Alberta we acquired lands through farm-out drilling and lease purchases, and blocked out gas reserves at Heathdale, Bigstone, Sunnynook and Oakland Lake. Many additional locations exist on Company lands and these will be drilled and developed when there is a gas market.

New gas production was placed on stream at Acadia Valley and Boyle, Alberta. Development drilling at Belloy in the Peace River area resulted in increased gas production while at the Dunvegan gas field, which contributes 31% of our revenue, reservoir studies conducted by the operator suggest that we may be able to increase the recoverable reserves by drilling more wells and recompleting some of the existing wells. These additional wells and recompletions are planned at Dunvegan in the coming year. In Louisiana, at our Cotton Valley field, gas and condensate production commenced around year end.

We have greatly appreciated the efforts of our nine employees during the past year, and look forward to continued growth in 1979.

On Behalf of the Board of Directors

J. E. Stobart, President

March 22, 1979
Calgary, Alberta



REVIEW OF 1978 OPERATIONS

DRILLING

Paloma Petroleum Ltd. and its subsidiaries participated in the drilling of 57 wells in 1978. We were the operator for 21 or 37% of the wells and our average participation was 31%. This drilling activity resulted in 35 gas discoveries, 6 oil discoveries and 16 dry holes. Two wells were drilled in southern Saskatchewan, 40 wells were drilled in eastern Alberta, 12 wells were drilled in the Peace River area of Alberta, 1 well was drilled in northeast British Columbia, and 2 wells were drilled in northwest Louisiana. Paloma's drilling record for the year is summarized as follows:

Wells	Gross	Net
Exploratory	35	12.8
Productive	23	8.6
Dry	12	4.2
Development	22	4.8
Productive	18	3.9
Dry	4	.9

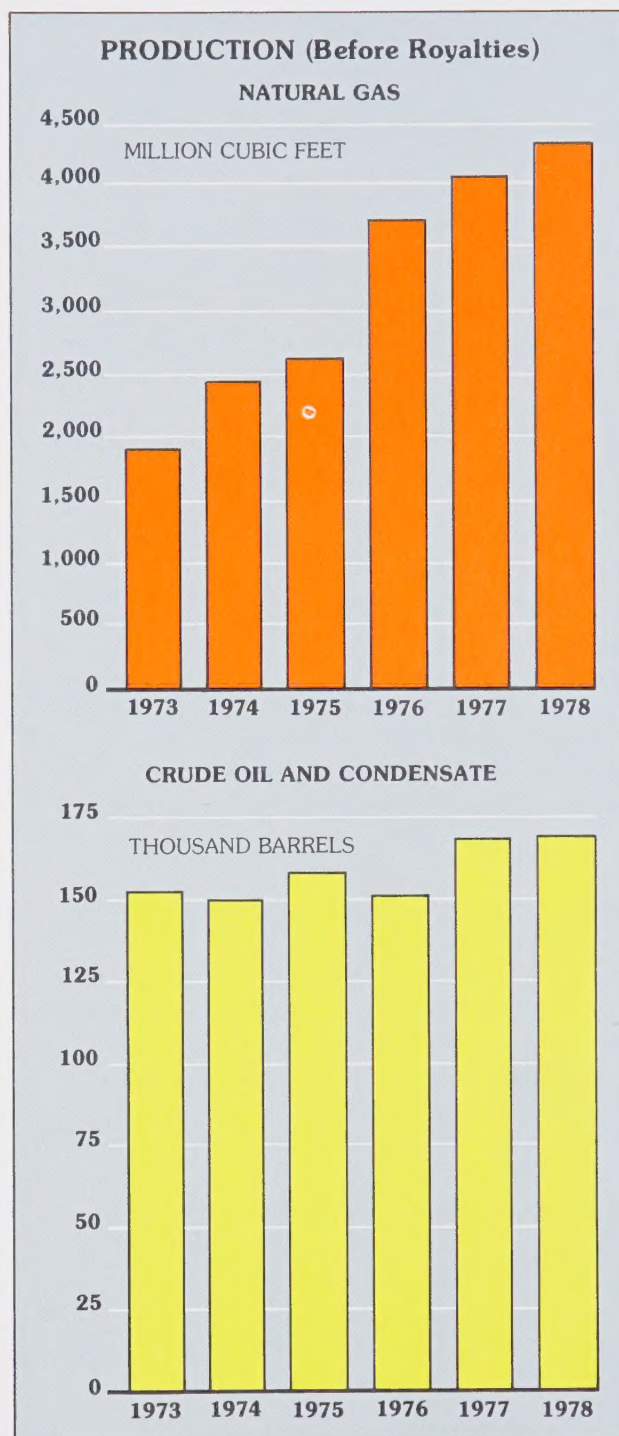
PRODUCTION

Natural Gas

Gas sales increased 7% to 4,298,169 thousand cubic feet in 1978 from 4,004,541 thousand cubic feet in 1977. Production was severely curtailed in the warmer months due to reduced market demand. This is evidenced by the fact that our average production rate in December, 1978 was 13.9 million cubic feet per day, compared to an average of 11.8 million cubic feet per day for the year.

Oil and Condensate

Crude oil and condensate production increased to 169,546 barrels in 1978 from 166,758 barrels in 1977.





RESERVES

(Before Deduction of Royalties)

DECEMBER 31, 1978

CRUDE OIL AND CONDENSATE

(barrels)

Province of Alberta	
Province of Saskatchewan	
U.S.A.	

TOTAL

Proved

Probable

Total

1,518,958	418,794	1,937,752
358,604	—	358,604
76,657	4,719	81,376
<u>1,954,219</u>	<u>423,513</u>	<u>2,377,732</u>

NATURAL GAS (MCF)

Province of Alberta:

Peace River Area	
Other	

U.S.A.

TOTAL

43,954,000	12,315,000	56,269,000
27,779,000	5,722,000	33,501,000
1,770,000	118,000	1,888,000
<u>73,503,000</u>	<u>18,155,000</u>	<u>91,658,000</u>

The Company's total proved and probable reserves at year-end were 91,658 million cubic feet of gas, representing a 21.3 year constant rate reserve life index, and 2,377,732 barrels of oil and condensate representing a 14.0 year constant rate reserve life index. Downward revisions to gas reserves were made in the Jarrow and Stanmore areas to ensure that re-

serve estimates are in line with current well capabilities. These revisions were necessary in keeping with the Company policy of maintaining accurate reserve estimates. Our 1978 drilling program was very successful, resulting in additions to reserves of 13,930 million cubic feet of natural gas and 274,512 barrels of crude oil and condensate.

PRICES AND MARKETS

The current average wellhead price for Alberta gas is \$1.57 per MCF and \$12.75 per barrel for oil. Price increases of \$1.00 per barrel are scheduled for July 1, 1979 and January 1, 1980. Gas price increases are expected, based on an 85 per cent heating value basis. It appears that future Canadian price increases will be significant, based on upward pressure of world crude prices and the need to develop the expensive heavy oil of Western Canada.

Prospects for future gas sales are better than last year as a result of the National Energy Board's estimate that there is 2 trillion cubic feet of Canadian gas available for export. TransCanada Pipelines, Pro Gas and Pan-Alberta Gas Ltd. have, or will soon have, applications before the National Energy Board for sale of the exportable surplus to the U.S.A. The sum of the applications will certainly be in excess of the 2 trillion cubic feet being proposed for export. It is industry's hope that the applications will support greater export volumes than those estimated as a result of the recent National Energy Board hearings. Paloma has committed most of its uncontracted gas reserves to Pan-Alberta Gas Ltd.

LAND HOLDINGS

December 31, 1978

	<u>Total</u>	
	<u>Gross Acres</u>	<u>Net Acres</u>
Alberta	789,054	105,325
British Columbia	1,282	738
Saskatchewan	9,049	1,665
U.S.A.	138,882	42,188
	<u>938,267</u>	<u>149,916</u>

The Company gross acreage increased 4% to 938,267 acres from 905,715* acres in the previous year. Net acreage of 149,916 acres increased 9% from 138,083* acres in 1977.

*Corrected acreage figures for 1977.



DUNVEGAN

Paloma sold 1,655 million cubic feet of gas and 13,876 barrels of condensate from the Dunvegan Gas Unit in 1978. Dunvegan continues to be the Company's largest source of oil and gas revenue, contributing 31% in the past year. Marketing problems at Dunvegan continued in 1978; the gas purchaser failed to take the minimum contract quantity, and thus Paloma received funds through the "take-or-pay" provision of the contract which allows the buyer 5 years to make up gas paid for but not taken. Paloma's interest in the Dunvegan Gas Unit is 4.3%.

Reservoir studies conducted by the operator have indicated uneven depletion across the field and have suggested that additional wells should be drilled and more intervals perforated in existing wells in order to optimize the recovery of gas from the various reservoirs. Additional wells and recompletions are therefore planned in 1979 in order to increase the recoverable reserves at Dunvegan.

BELLOY

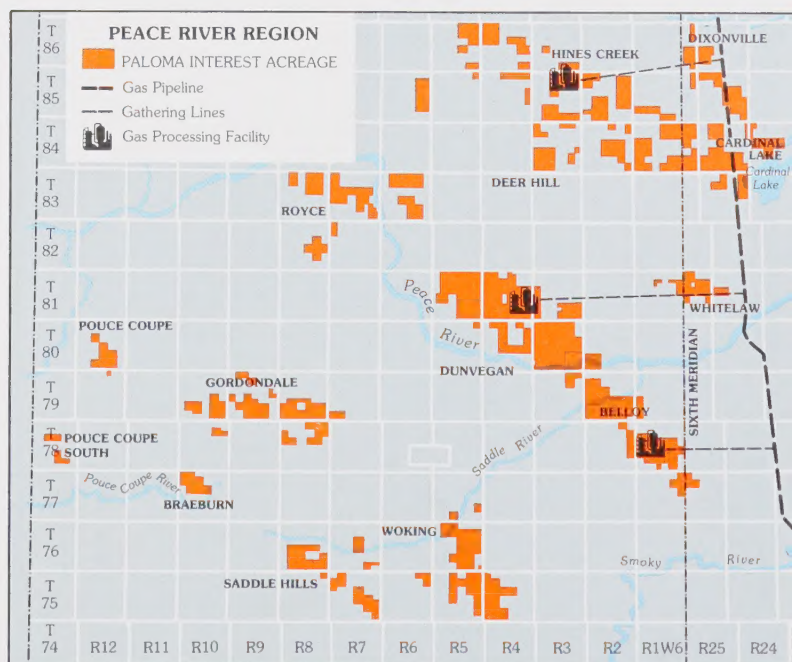
Our gas sales from Belloy increased 19% to 590 MMCF during 1978. Four wells were drilled during the past year and the field is now producing at 8.8 MMCF per day. Paloma's average interest in the Belloy production is 18%.

PEACE RIVER AREA

The Company has interests in 394,027 gross acres (21,077 net acres) in the Peace River area. This acreage is mostly undeveloped, with 394 sections yet to be drilled and we are optimistic about its future exploration potential. Of the 12 Peace River wells in which we participated during 1978, 7 wells were exploratory of which 4 were completed as gas wells. In addition, seismic work was done and as the prospect of future gas markets improves, we expect to devote more of our exploration efforts to the Peace River area.

We continue to produce at Hines Creek at the rate of 4.8 MMCF per day and our net interest is 8.33%. At Dixonville, there are 3 shut-in gas wells. The potential at Dixonville is 4 MMCF per day and the Company's interest is 8.33%. We have small interests in 2 shut-in gas wells at Cardinal Lake, 1 gas well at Whitelaw and 1 gas well at Gordondale.

Paloma joined the operator in pledging some of our shut-in gas reserves in the Peace River area to Pan-Alberta Gas Ltd. in support of their current export application to the National Energy Board.



WEST HOTCHKISS

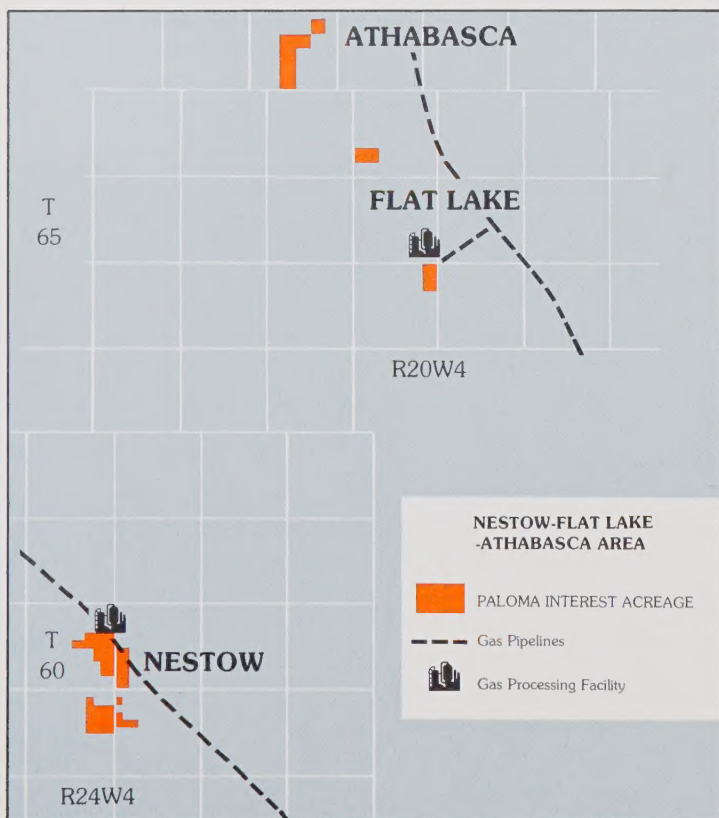
West Hotchkiss is 235 kilometers north of Grande Prairie, Alberta. Paloma has an interest in 4 shut-in gas wells and 16,690 gross acres (2,532 net acres) located 8 kilometers west of a major gas trunk line. The gas potential of this area has attracted considerable industry interest in recent years and we expect to do further drilling when a gas market is available. We have pledged our reserves in the West Hotchkiss area to Pan-Alberta Gas Ltd. in support of their current export application to the National Energy Board.

NESTOW-FLAT LAKE-ATHABASCA

These fields are located 70 to 135 kilometers north north-east of Edmonton.

Nestow production currently averages 2.3 MMCF per day and our interest is 33%. During 1978 there was a shut-down of 110 days due to a lack of gas market. The Company holds 7,840 gross acres (3,057 net acres) in the Nestow area and our lands are now largely developed.

At Flat Lake there are 2 wells currently producing 700 MCF per day in which we have a 26% interest. In addition, we have a 22% interest in a shut-in gas well which was drilled during 1978. We hold 2,560 gross acres (652 net acres) at Flat Lake.



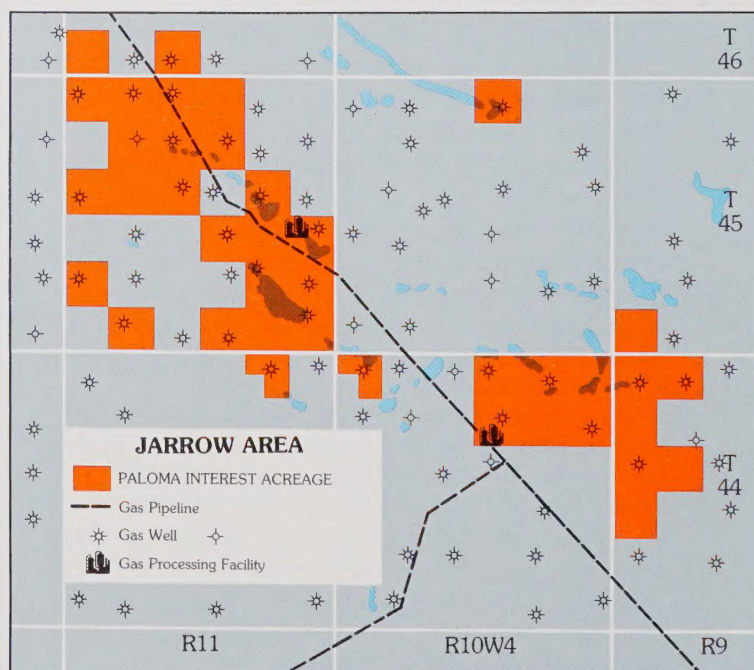
At Athabasca we joined in an exploration venture in 1978 where we hold 3,200 gross acres (566 net acres) and have 1 shut-in gas well in which Paloma's interest is 20%.

EAST CENTRAL ALBERTA

The Company's production at Jarrow in 1978 was 814 MMCF, a 10% increase over the previous year. This was due to the drilling of 4 additional wells and the upgrading of production facilities during the year. We hold 24,960 gross acres (7,795 net acres) at Jarrow.

At our Stanmore field, located 250 kilometers east north-east of Calgary, we drilled 4 additional wells in 1978 which resulted in 3 gas wells and 1 dry hole. The field was virtually shut down for 4 months in the summer due to a lack of gas market. Present production averages 4.8 MMCF per day, of which the Company's share is 1.5 MMCF per day. Our land at Stanmore comprises 22,880 gross acres (9,685 net acres). There is scope for additional drilling on this acreage when increased deliverability is required.

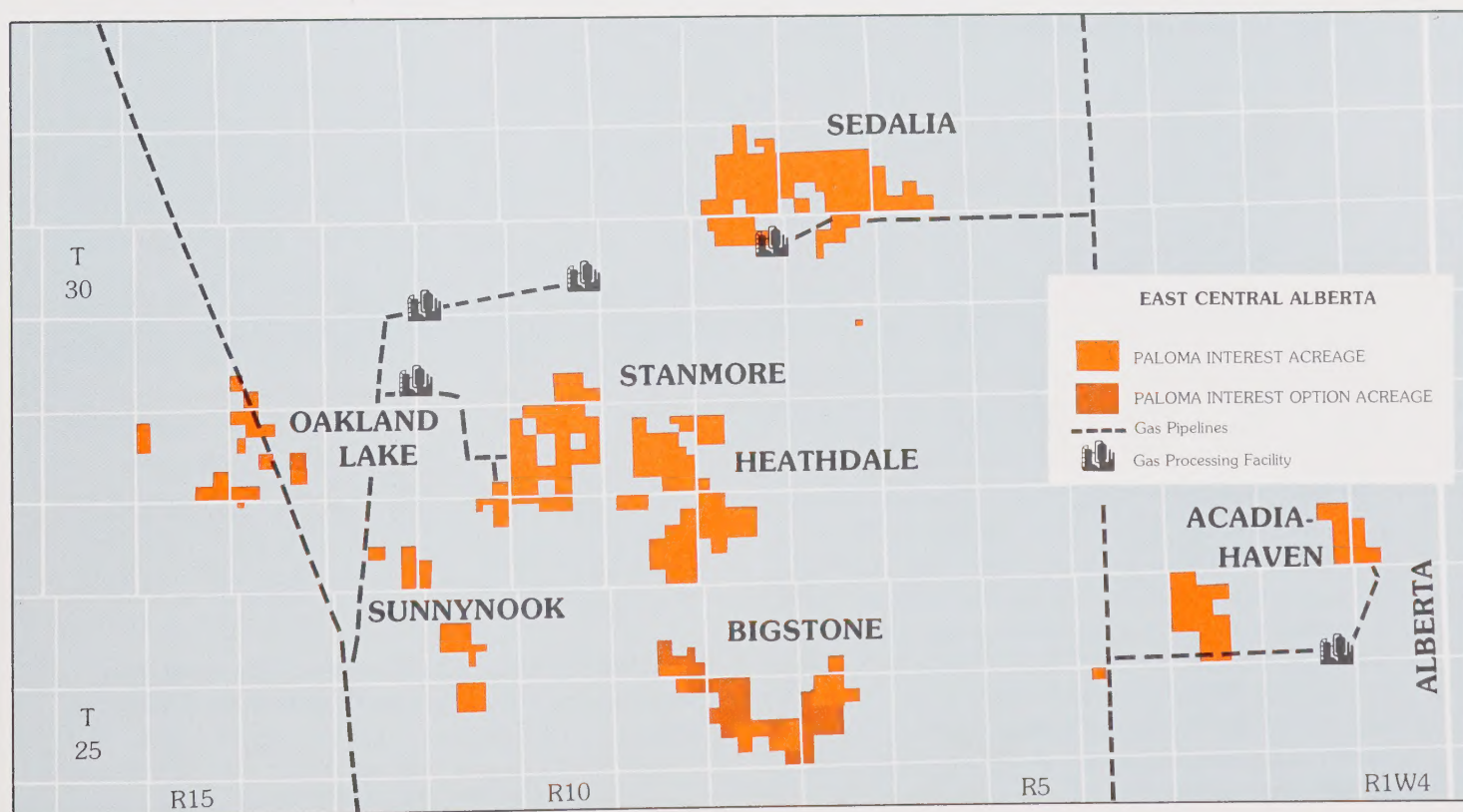
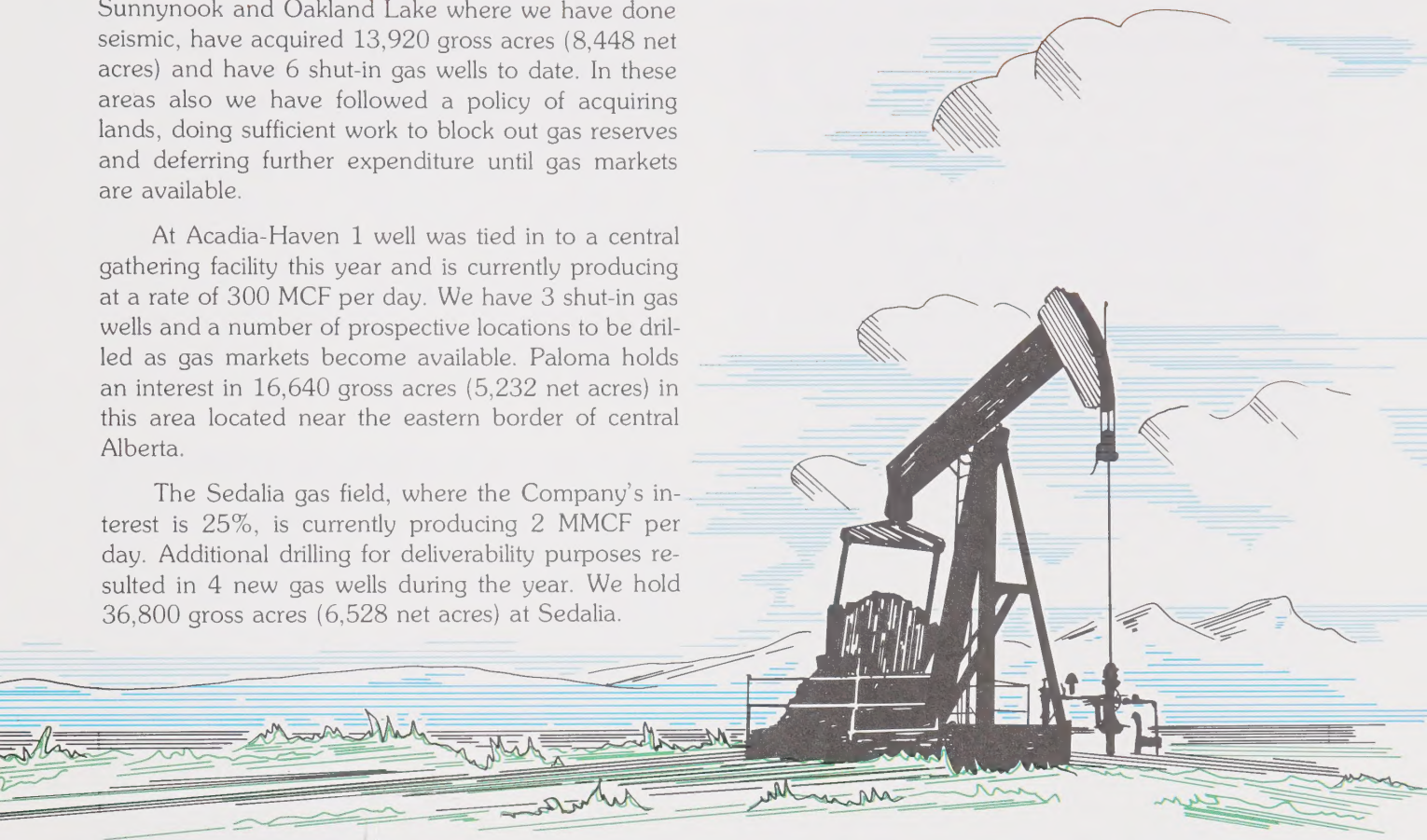
In the Heathdale area, 20 kilometers east of Stanmore, we took a major farmout in 1978 involving 28,320 gross acres in which the Company's interest is now 5,038 net acres. Following seismic surveys, we drilled 6 successful gas wells, 2 of which also found oil in the Detrital zone and are currently undergoing extended production tests. Significant gas reserves have been blocked out at Heathdale, however, further development drilling is not planned until a gas market is in sight.



Other exploration is in progress at Bigstone, Sunnynook and Oakland Lake where we have done seismic, have acquired 13,920 gross acres (8,448 net acres) and have 6 shut-in gas wells to date. In these areas also we have followed a policy of acquiring lands, doing sufficient work to block out gas reserves and deferring further expenditure until gas markets are available.

At Acadia-Haven 1 well was tied in to a central gathering facility this year and is currently producing at a rate of 300 MCF per day. We have 3 shut-in gas wells and a number of prospective locations to be drilled as gas markets become available. Paloma holds an interest in 16,640 gross acres (5,232 net acres) in this area located near the eastern border of central Alberta.

The Sedalia gas field, where the Company's interest is 25%, is currently producing 2 MMCF per day. Additional drilling for deliverability purposes resulted in 4 new gas wells during the year. We hold 36,800 gross acres (6,528 net acres) at Sedalia.





LOUISIANA

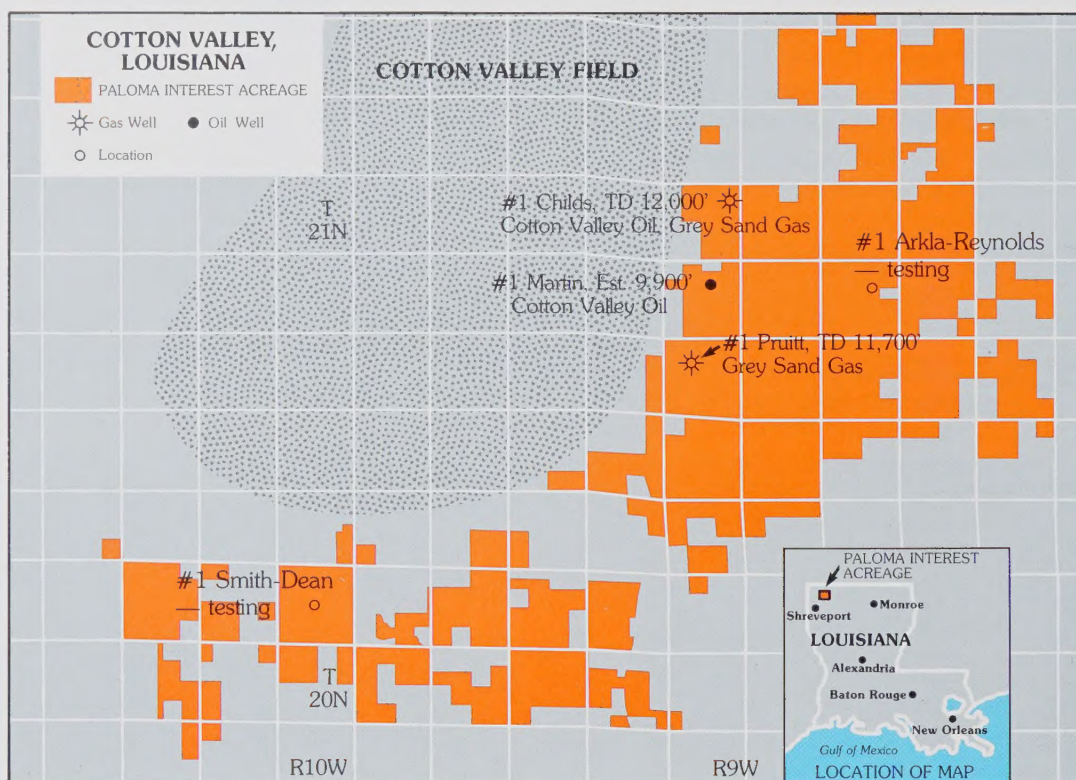
The Company holds a 3.75% working interest plus a .94% overriding royalty on 22,000 acres on the edge of the Cotton Valley field located 60 kilometers northeast of Shreveport, Louisiana. At present we have 3 gas wells completed in the Jurassic Smackover (Grey) Sand, and 1 potential oil well in the Cotton Valley formation. Two of the gas wells are on stream selling 1.5 million cubic feet of gas plus 30 barrels of condensate per day. In addition, the Arkla Corporation recently drilled a 12,700' farmout well on our land which found gas in the Grey Sand in non-commercial quantities. The well is currently plugged back for testing in the Cotton Valley formation.

ARKANSAS

Along the eastern extension of the Arkoma basin we have a 33% interest in 106,000 acres. A number of gas fields lie on trend to the west of our lands, however, the area of our lands is only starting to receive exploration attention by the industry. Our aim is to negotiate a multi-well farmout of our holdings in this area.

OKLAHOMA

The Company had a 50% interest in a 12,000 acre block in the Arkoma basin of eastern Oklahoma. Following geological evaluation, we farmed out 50% of our holdings for the drilling of a 10,000' exploration well which did not find commercial hydrocarbons, and was abandoned.



HOTEL AND REAL ESTATE

The Company's subsidiary, Compass Investments of Alberta Limited, sold the Mayfair Hotel in Edmonton in the summer of 1978. This completes the sale of the Company's entire hotel interests and is in accordance with the Company policy of concentrating its efforts in the area of oil and gas exploration and development. Several other properties were also sold during 1978 with the major portion of the proceeds being invested in oil and gas projects during 1978.

The Company continues to operate seven cafeterias located in Calgary and Edmonton and owns and leases out a small shopping centre in Drayton Valley.

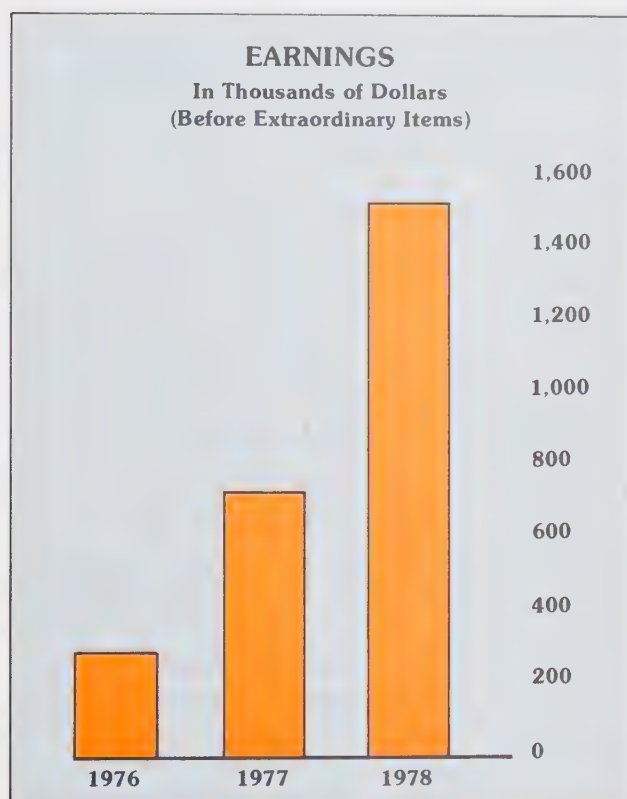
The reduction of income from the hotel operations reflects the sale of the Mayfair Hotel during the year.



FINANCIAL REVIEW

EARNINGS

Net earnings for the year ended December 31, 1978 amounted to \$2,121,599 (\$.49 per share), an increase of 105% from \$1,037,097 (\$.24 per share) in 1977. Earnings before extraordinary items amounted to \$1,555,152 (\$.36 per share) for 1978, an increase of 113% from \$728,419 (\$.17 per share) for 1977. Return on average shareholders' equity, before extraordinary items, increased to 26.8% from 21.1% in 1977. The chart below shows earnings before extraordinary items and points to the significant increase in earnings from 1976 to 1978. As a result of a corporate re-structure in December, 1975, all of the comparative charts have been prepared for the years 1976, 1977 & 1978.

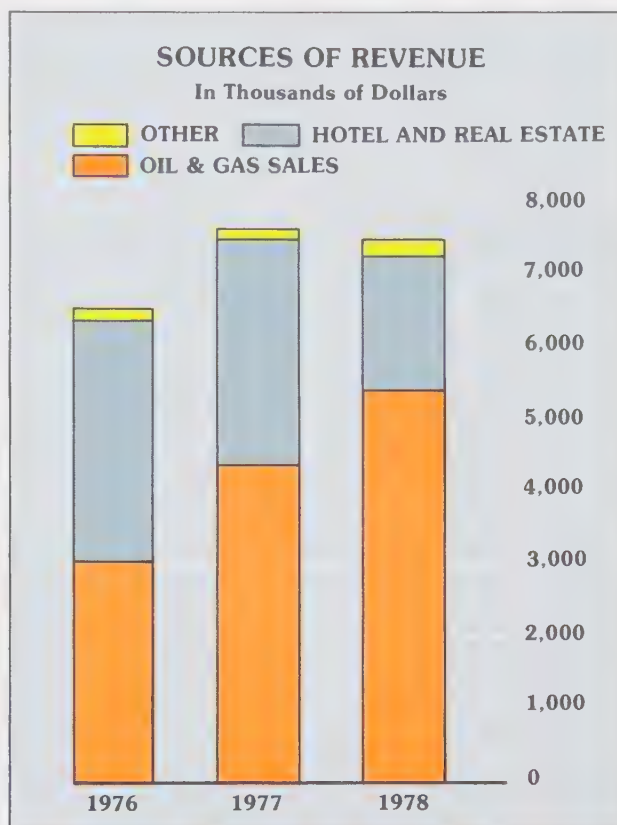


REVENUE

Revenues of \$7,563,689 for 1978 amounted to a decrease of 2% from the previous year. The decrease in total revenues reflects the sale of the Company's remaining hotel interest in the summer of 1978. Hotel and real estate revenues decreased 41% in 1978 to \$1,898,059 from \$3,236,557 in 1977.

Sales of crude oil and natural gas amounted to \$5,409,830, an increase of 23% from \$4,405,186 in 1977. Higher wellhead prices for both crude oil and natural gas plus a 7% increase in natural gas sales volume contributed to the increased revenue.

The Company policy is to continue to concentrate on oil and gas exploration and development. As the chart indicates, there has been a noticeable reduction in hotel and real estate revenue for the three years. However, oil and gas revenue has increased at a rate in excess of 20% per year.



CHANGES IN FINANCIAL POSITION

Funds provided from operations increased 42% to \$3,790,372 from \$2,662,140 in 1977.

Working capital at December 31, 1978 amounted to \$4,945,727 compared to a deficiency of \$192,416 at the end of the previous year. Several notable occurrences during 1978 have contributed to this exceptional increase:

A) the proceeds from the sale of several hotel and real estate interests, including the Mayfair Hotel in Edmonton, as well as the Company's oil and gas interest in the Wainwright, Alberta area realized the Company in excess of \$4,000,000.

B) the Company was successful in re-structuring its long-term debt. A \$12,000,000 loan was negotiated with the proceeds being used to retire the previously existing production loans. The new loan confers several distinct advantages on the Company: the term of the loan is 12 years with interest pay-

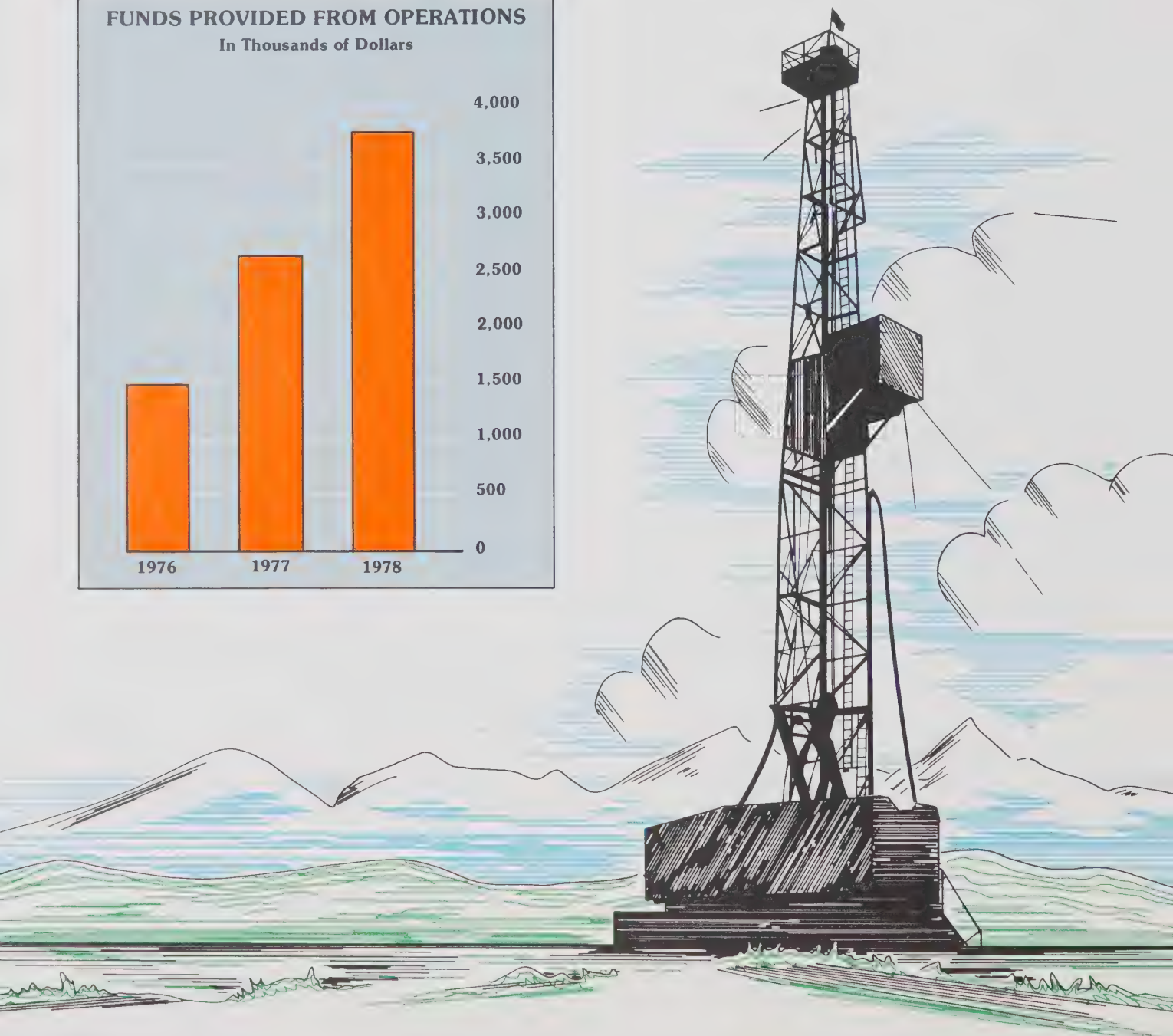
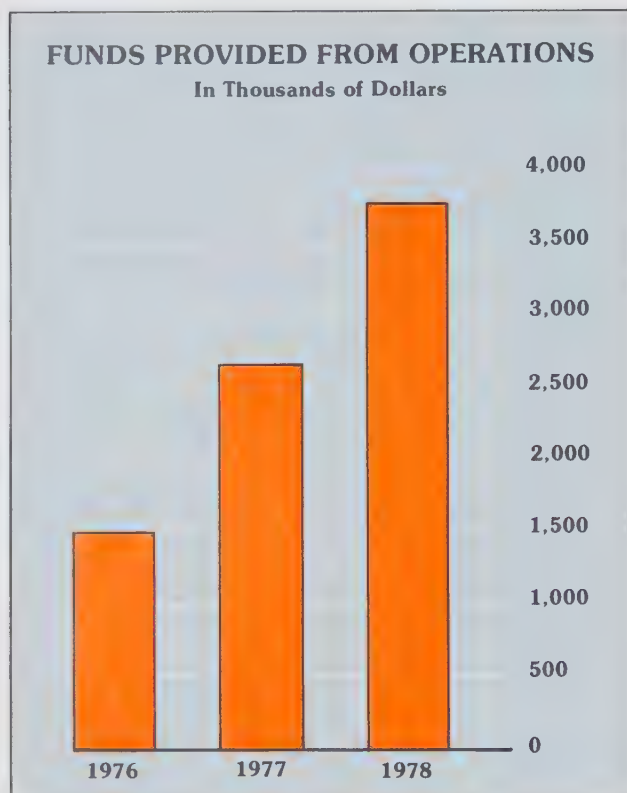
ments only for the first three years; the loan is secured only by the Company's interest in the Dunvegan Unit; the remaining Company properties are now available for security for possible future acquisitions.

C) as a result of restricted gas markets over the past two years, the transmission companies have incurred a take-or-pay obligation in many contracts. The Company received \$525,843 in take-or-pay payments during 1978. This amount is recorded as deferred revenue and will not be booked as current revenue until such time as the gas is delivered.

Capital expenditures for 1978 increased 19% to \$4,216,525 from \$3,533,027 in 1977. The major portion of the 1978 expenditures pertained to petroleum exploration and development in Alberta.

OUTLOOK FOR 1979

Despite apparent gas marketing restrictions which will undoubtedly create a levelling-off of petroleum sales in 1979, the Company expects to enjoy another financially successful year.





AUDITOR'S REPORT TO THE SHAREHOLDERS

We have examined the consolidated balance sheet of Paloma Petroleum Ltd. as at December 31, 1978 and the consolidated statements of earnings and retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at December 31, 1978 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Calgary, Canada
March 13, 1979

Peat, Marwick, Mitchell & Co.
Chartered Accountants



CONSOLIDATED BALANCE SHEET

December 31, 1978

(with comparative figures for 1977)

Assets

	1978	1977
Current assets:		
Cash	\$ 3,694,536	\$ 1,158,909
Accounts receivable	2,403,182	1,522,682
Due from affiliated company	385,000	124,000
Prepaid expenses and supplies	36,267	74,188
Total current assets	6,518,985	2,879,779
Property, plant and equipment (Note 2)	21,250,905	20,895,523
Less accumulated depletion and depreciation	3,742,876	3,128,760
	17,508,029	17,766,763
Other assets:		
Agreements for sale receivable, net of current portion	57,950	81,988
Video tapes, at cost less amortization of \$186,627 (1977 — \$124,418)	248,839	311,049
Drilling and other deposits, at cost	51,826	68,496
Sundry investments	28,227	6,429
Financing costs, at cost less amortization of \$67,037 (1977 — \$43,204)	67,039	90,872
	453,881	558,834
Goodwill, at cost less amortization of \$74,221 (1977 — \$54,010)	545,694	756,153
	\$25,026,589	\$21,961,529

Liabilities and Shareholders' Equity

	<u>1978</u>	<u>1977</u>
Current liabilities:		
Accounts payable and accrued liabilities	\$ 1,451,624	\$ 553,166
Current portion of long-term debt	121,634	2,519,029
Total current liabilities	<u>1,573,258</u>	<u>3,072,195</u>
Deferred revenue	525,843	—
Long-term debt (Note 3)	12,759,369	12,097,480
Deferred income taxes	2,694,352	2,309,415
Minority interest in subsidiary companies	—	336,721
Shareholders' equity:		
Share capital (Note 4):		
Common shares without nominal or par value.		
Authorized 7,000,000 shares; issued		
4,490,224 (1977 — 4,289,149)	2,715,232	1,508,782
Contributed surplus	338,000	338,000
Retained earnings	4,420,535	2,298,936
	<u>7,473,767</u>	<u>4,145,718</u>
	<u>\$25,026,589</u>	<u>\$21,961,529</u>

Approved on behalf of the Board on March 13, 1979

 , Director

 , Director

See accompanying notes.



CONSOLIDATED STATEMENT OF EARNINGS AND RETAINED EARNINGS

Year ended December 31, 1978

(with comparative figures for 1977)

	1978	1977
Revenues:		
Oil and gas (net of royalties of \$3,243,596; 1977 — \$2,414,465)	\$5,409,830	\$4,405,186
Hotel and real estate	1,898,059	3,236,557
Other	255,800	89,059
	7,563,689	7,730,802
Expenses:		
Oil and gas production	686,771	669,675
Mining properties surrendered	—	165,675
Hotel and real estate	1,453,545	2,642,020
General and administrative	681,307	625,251
Interest on long-term debt	1,426,744	1,345,264
Depletion	808,707	658,986
Depreciation	342,437	322,770
Amortization	106,252	110,817
	5,505,763	6,540,458
Earnings before income taxes, minority interest and extraordinary items	2,057,926	1,190,344
Income taxes:		
Current	124,916	248,234
Deferred	914,937	582,309
Province of Alberta Royalty Tax Credit	(599,966)	(461,782)
	439,887	368,761
Earnings before minority interest and extraordinary items	1,618,039	821,583
Minority interest in earnings of subsidiaries	62,887	93,164
Earnings before extraordinary items	1,555,152	728,419
Extraordinary items (Note 5)	566,447	308,678
Net earnings	2,121,599	1,037,097
Retained earnings at beginning of year	2,298,936	1,261,839
Retained earnings at end of year	\$4,420,535	\$2,298,936
Earnings per share:		
Before extraordinary items	\$ 0.36	\$ 0.17
Extraordinary items	0.13	0.07
	\$ 0.49	\$ 0.24

See accompanying notes.



CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

Year ended December 31, 1978

(with comparative figures for 1977)

	1978	1977
Funds provided:		
Earnings before extraordinary items	\$ 1,555,152	\$ 728,419
Add items not requiring an outlay of funds:		
Depreciation	342,437	322,770
Depletion	808,707	658,986
Amortization	106,252	110,817
Deferred income taxes	914,937	582,309
Minority interest	62,887	93,164
Mining properties surrendered	—	165,675
Funds provided from operations	3,790,372	2,662,140
Gain on sale of marketable securities	—	412,307
Proceeds on sale of property, plant and equipment	4,357,654	1,163,309
Increase in long-term debt	661,889	2,900,000
Issue of share capital	1,206,450	337,500
Reduction in agreements for sale receivable	24,038	45,289
Reduction in drilling and other deposits	16,670	—
Deferred revenue	525,843	—
	10,582,916	7,520,545
Funds applied:		
Purchase of property, plant and equipment	4,216,525	3,533,027
Increase in sundry investments	21,798	—
Reduction in long-term debt	—	2,409,371
Purchase of additional shares in a subsidiary	1,206,450	337,500
	5,444,773	6,279,898
Increase in working capital	5,138,143	1,240,647
Working capital deficiency at beginning of year	192,416	1,433,063
Working capital (deficiency) at end of year	\$ 4,945,727	\$ (192,416)

See accompanying notes.



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 1978

1. Summary of Significant Accounting Policies:

a) Principles of Consolidation:

The consolidated financial statements include the accounts of all subsidiaries, each of which is wholly-owned. During the year, the Company acquired the remaining 8.55% of the outstanding shares of Compass Investments of Alberta Limited (Note 4) and the remaining 40% of the outstanding shares of Grenville Explorations Limited.

b) Property, Plant and Equipment:

The Company follows the full cost method of accounting for oil and gas properties whereby all costs relating to the exploration and development of oil and gas reserves are capitalized. Such costs include those related to lease acquisitions, geological and geophysical activities, carrying charges of non-producing properties, drilling both productive and non-productive wells and overhead related to exploration. Proceeds from minor property sales are reflected as a reduction of the total capitalized costs; gains or losses on significant property sales are recognized in the statement of earnings.

Depletion of oil and natural gas properties and depreciation of production and other equipment are calculated on the composite unit-of-production method, based on estimated proven reserves, as determined by company engineers. Depreciation of the hotel and real estate assets is calculated on a straight-line basis at the following rates:

Building	4% - 5%
Equipment	.5% - 10%

c) Other Assets:

Video tapes are being amortized on a straight-line basis over seven years.

Financing costs are being amortized on a straight-line basis over six years.

d) Goodwill:

Goodwill, representing the excess of the purchase price of a subsidiary over the fair value of net assets acquired at the date of purchase, is being amortized on a straight-line basis over thirty years.

e) Deferred Revenue:

Deferred revenue represents amounts received in respect of "take-or-pay" natural gas contracts. Such amounts have been deferred pending ultimate natural gas delivery or expiration of the contractual delivery period.

f) Joint Interest Operations:

Substantially all of the Company's oil and gas exploration and production activities are conducted jointly with others and accordingly the accounts reflect only the Company's proportionate interest in such activities.

2. Property, Plant and Equipment:

	1978	1977
Oil and gas:		
Petroleum and natural gas properties,		
at cost	\$16,406,519	\$13,275,529
Less accumulated depletion	2,839,684	2,079,990
	13,566,835	11,195,539
Production and other equipment, at cost	3,681,027	3,159,413
Less accumulated depreciation	806,606	658,755
	2,874,421	2,500,658
	16,441,256	13,696,197

	1978	1977
Hotel and real estate:		
Land, buildings, equipment and improvements, at cost	1,163,359	4,460,581
Less accumulated depreciation	96,586	390,015
	<u>1,066,773</u>	<u>4,070,566</u>
	<u>\$17,508,029</u>	<u>\$17,766,763</u>

Effective July 31, 1978, the Company sold all of its hotel assets.

3. Long-term Debt:

	1978	1977
Term bank loans, secured by certain petroleum and natural gas properties	\$12,517,287	12,790,000
First mortgages and agreements for sale	70,049	1,532,842
Note payable on video tapes, unsecured, non-interest bearing, due 1981	293,667	293,667
	<u>12,881,003</u>	<u>14,616,509</u>
Deduct current portion of long-term debt	121,634	2,519,029
	<u>\$12,759,369</u>	<u>\$12,097,480</u>

On the \$12,000,000 term bank loan equal monthly repayments, blended as to interest and principal, commence in 1982 with the final instalment due in 1990. The remaining \$517,287 is repayable by monthly instalments of interest and principal of \$12,000. Interest on both loans is calculated at 1½% over the banks' prime lending rates.

4. Share Capital:

Effective November 30, 1978, the Company issued 201,075 common shares in exchange for all the shares owned by the minority shareholders of a subsidiary company. The shares were issued for an aggregate consideration of \$1,206,450, of which \$522,900 was applied to the minority interest and \$683,550 was allocated to petroleum and natural gas properties.

5. Extraordinary Items:

	1978	1977
Reduction of deferred income taxes resulting from application of drilling and exploration expenses by certain subsidiaries	\$100,000	109,770
Gain on sale of marketable securities, net of applicable income taxes in the amount of \$152,946	—	412,307
Gain (loss) on sale of hotels and real estate, net of applicable income taxes of \$295,000 (current — \$725,000, deferred recovery — \$430,000) and minority interest of \$123,292	466,447	(213,399)
	<u>\$ 566,447</u>	<u>\$ 308,678</u>

6. Remuneration:

The aggregate remuneration paid to directors and senior officers during the year amounted to \$253,616 (1977 — \$205,232).



Paloma Petroleum Ltd.
